Brexit update

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Four months after the results of the British referendum

Generally speaking, British entrepreneurs seem confident about the development of the UK national economy. The country seems to have overcome the initial shock that followed the referendum. The British economy is picking up once again and in the second quarter even recorded growth of 0.6%. Production in UK industry and manufacturing orders are once again on the rise and the Bank of England has introduced a range of measures to prevent the country from slipping into recession. And yet the situation remains remarkably uncertain.

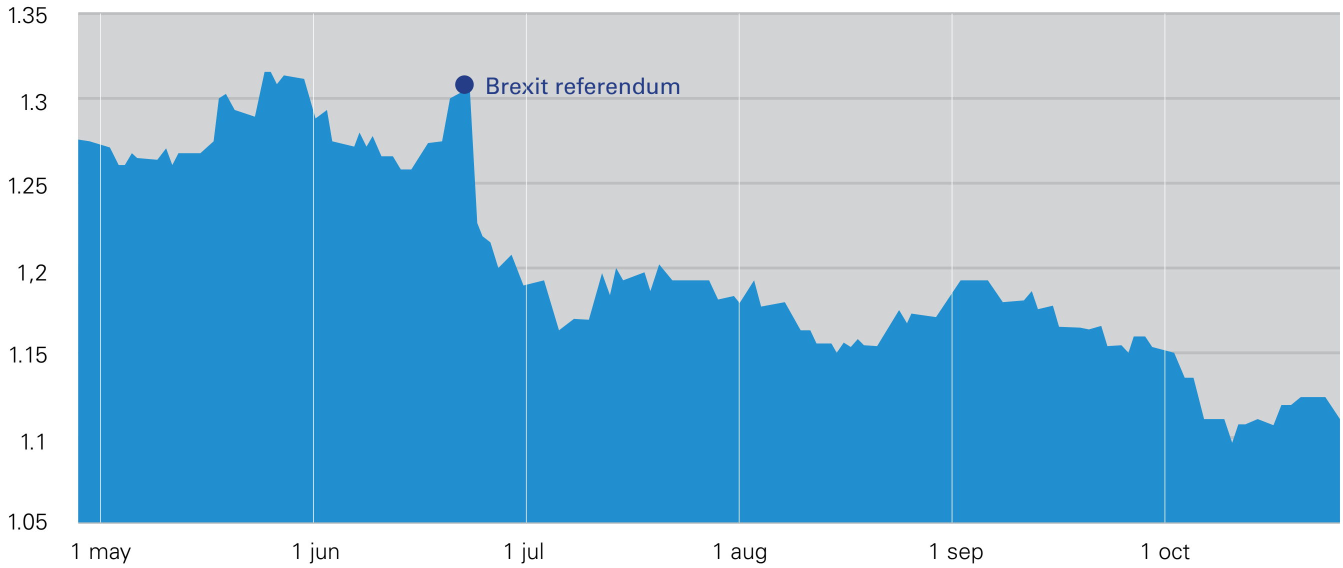
— The devaluation of the British pound (18% since June 2016) and the warning from the British Prime Minister, Theresa May, that "the Brexit will harm the economy of the UK", might indicate that the UK is facing difficult times ahead.

— The Economist describes it as follows: "A hard Brexit ejects the UK immediately from Europe's Internal Market, in exchange for which we get the opportunity to do ourselves more harm by reducing migration."

— KPMG's '100 UK CEOs' survey described the impact of the current development on British C-suite level managers. It turns out that three-quarters of British CEOs are assessing the possibility of moving their head office or part of their business operations out of the UK. The reasons they give for this are the uncertain future and the chance that trade between the member states of the EU and UK will only become more difficult.

— And then there is the ruling of the British High Court, which in early November concluded that the government requires permission from parliament to initiate the Article 50 procedures. Article 50 will launch the exit process and Theresa May believed the government was bound to follow the outcome of the referendum with or without permission from the British parliament. A group of British

Euro – Pound Sterling exchange rate since May 2016



Exchange rates 2016

investors took the matter to the courts and 'won'. The Lord Chief Justice, Lord Thomas of Cwmgiedd, ruled that "the most fundamental rule of the UK constitution is that parliament is sovereign". The British government will appeal the ruling. And the Supreme Court has set aside time for the appeal in early December. If the Supreme Court confirms the High Court's decision, this will trigger a long period of debates in the House of Commons. After all, a majority of MPs was against Brexit, but there was also a large majority in favor of the referendum. It is considered likely that if parliament does indeed get a say on the triggering of the exit procedure, that this will greatly increase the chances of a soft Brexit.

Theresa May has announced that she will submit the application for the exit procedure to the EU no later than in March 2017. The exit procedure is expected to take at least two years. During that time, the EU and UK will remain in uncertainty about the future cooperation between the two parties. This uncertainty will last at least two years and won't be completely removed after that time either. Because the question remains as to how the negotiations will progress. Will there be a hard Brexit? Will any cooperation agreement whatsoever be reached between the EU and the UK? And what will be the effect on elections in France and Germany, for instance, on the position of the EU member states in this process?

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What does Theresa May want; what does the new British model entail?

The UK will formally inform the EU before April 2017 that it is invoking article 50 of the European Union Treaty. The negotiations on the exit must be completed within two years, unless all other 27 member states unanimously decide to extend the negotiations. It seems very likely that the Brexit will be effected no later than April 2019.

THE BRITISH MODEL

Theresa May has indicated there are four key issues she wants to realize for the UK:

- Self-determination on immigration policy
- No judicial power for the European Court of Justice in the UK
- No financial contributions to the EU
- No adoption of rules if the UK has had no influence in the introduction of same

In addition, May will put into effect a Great Repeal Bill in March of 2017, which the UK will use to revoke the European Communities Act (ECA) of 1972. This act confirmed the UK's membership of the EU and ensures that EU legislation prevailed over British national legislation. This will no longer be the case after the annulment of the ECA. The British wish to adopt all EU legislation prevailing at that time and subsequently decide which components of that legislation will remain in force in the UK.

May wants the UK to become a sovereign and independent country again, in her own words: "*There will no longer be a mechanism to impose rules on Britain without the consent of our elected representatives.*"

Given these requirements, it will be virtually impossible for the UK to remain a member of the European Internal Market. The free traffic of people and the judicial powers of the European Court of Justice are indispensable for that. What is more, the difference between European law and British law will only increase over time. The UK will no longer automatically adopt new rules and legislative unity of law is no longer safeguarded by a single highest judicial body.

A COMPLETE EXIT, BUT WHAT NEW FORM OF COOPERATION WILL THERE BE?

There is a considerable chance that the two-year exit process will be too short a period of time to reach agreement on the new relationship the UK might want with the EU. That means that the UK will leave the EU in April 2019, but that it is highly unlikely that a new cooperative framework will have been agreed. One of the difficult issues, for instance, will be the UK's demand that it retains a say in the creation of European legislation, while it is no longer a member of the EU and does not recognize the judicial authority of the European Court of Justice. That will be difficult to reconcile.

If there is no framework cooperation agreement between the UK and the EU in April 2019, it means that trade between the two will fall back on the rules of the World Trade Organization (WTO). Cooperation with the UK will then be no different than cooperation with a country such as Russia or China.

Unless…. a transitional arrangement is agreed, under which the UK does leave the EU, but many of the de facto relationships as they exist today as part of the EU membership remain in place.

Despite the strong language from Theresa May and demands in terms of sovereignty and independence, the UK is also looking towards reciprocal trade interests of the EU and the UK. In the words of Theresa May: "We must talk to our European partners about a cooperation that is beneficial to both parties. We do not intend to continue the relationship with the other 27 EU countries as if we are a friendly third-party nation, such as South Korea."

All in all, a lot of uncertainty and volatility remains and the UK seems to be heading towards a complete separation from the EU while the new form of cooperation has not yet been decided.

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The consequences of the new British model

WHAT WILL A COMPLETE UK EXIT MEAN TO THE NETHERLANDS?

In a previous message from KPMG Nederland about the Brexit, it was already clear that the UK has a special position for the Netherlands. As a member of the EU, the Netherlands will face the harsh reality of the UK's exit. It is our second largest export country; 9% of our goods exports go to the UK. And our services sector has also benefitted from exports to the UK. On top of this, the Netherlands has considerable investments in the UK.

The Central Planning Bureau has calculated that the Netherlands' gross domestic product (GDP) will be 0.7% lower in 2018 as a result of the direct impact of the UK's exit from the EU. The Dutch economy has recovered from the crisis in recent years, but the uncertainties surrounding the Brexit will have a temporary negative impact on consumer spending and investments. According to the CPB prognosis, the Brexit will have a negative impact of 0.4 percentage points on growth and 0.2 percentage points on natural gas production.

If the UK leaves the EU in two years' time without a new cooperation agreement, it will fall back on the agreements of the WTO treaty. The WTO treaty is aimed at encouraging trade between countries across the globe, but even if only WTO regulations apply, the Netherlands will be affected more severely than other European countries:

- Dutch exports would be subject to an average levy of 5.5%, while the EU average is 4.9%.
- More than two-thirds of Dutch exports to the UK will be subject to a levy of between 2.5% and 5.0%. This applies in particular to chemicals and electrical appliances.
- One-tenth of Dutch exports to the UK consists of vegetables, fruit and flowers. Companies trading in that sector will face levies of between 10.5% and 17.5%.
- Dutch fisheries unions fear that if the UK leaves the EU, it will close its territorial waters to foreign fishing boats, while a large proportion of the Dutch fishing fleet catches its fish inside the British 200-mile zone.

WHAT ARE THE CONSEQUENCES FOR TRADE BETWEEN THE UK AND THE EU?

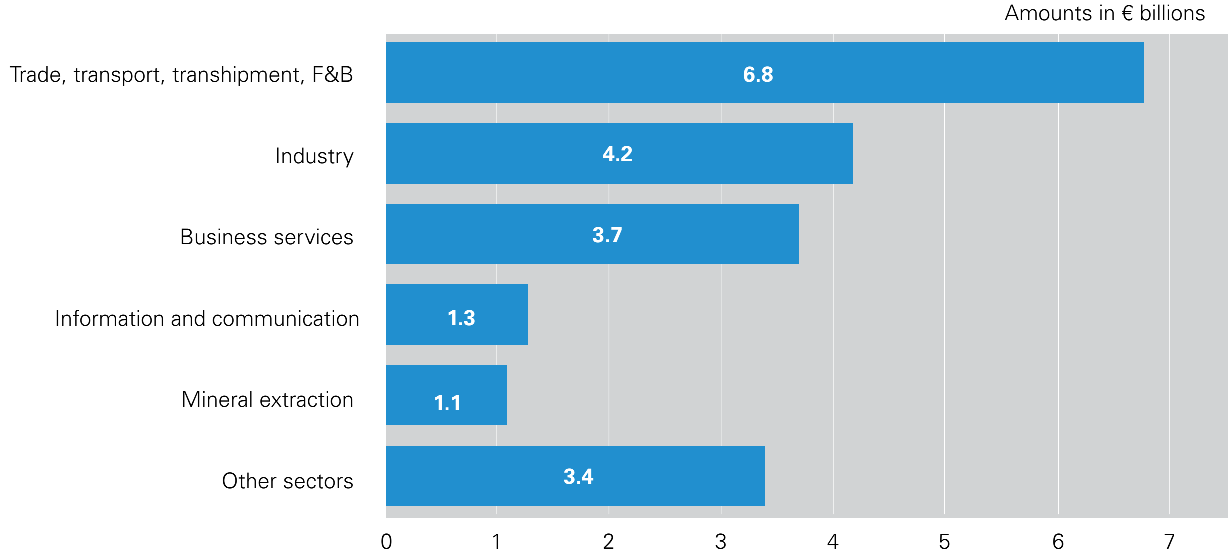
The EU is a customs union with free traffic of goods between the member states. Following the Brexit, the UK will no longer be part of the European customs union. It is not inconceivable that imports from the UK into the EU will be subject to customs levies after Brexit. These export products, which are currently subject to free trade agreements, would become more expensive.

An exit from collective trade agreements could result in extra throughput times between the UK and the EU. All goods will need to be cleared by customs in both the EU and the UK. That has a direct impact on the supply chain, IT and handling costs.

The key financial consequences of the Brexit in the field of customs:

- Customs handling costs will arise as a result of customs formalities
- Goods traffic may become subject to customs levies.
- The UK can no longer benefit from the EU's free trade agreements with non-EU countries such as the US, China, Mexico, Switzerland and South Korea.
- The UK will have to negotiate its own free trade agreements independently.

Dutch business sectors' contribution to revenues



Source: CBS

- Rules of origin may result in customs levies being raised on production in the EU and the UK.
- Head offices established in the UK may be assigned a higher customs value, since intercompany transactions will no longer be treated as domestic sales after the Brexit.
- To avoid double customs levies, the use of one or more customs permits may be required (for instance: customs warehousing and inward processing).

WHICH CONSEQUENCES OF THE BREXIT PROCESS CAN WE ALREADY SEE TODAY?

The British pound continued to fall against the euro after Prime Minister Theresa May announced the exit procedure would be launched no later than March 2017. This is not in itself surprising news, but it does seem to have served as a wake-up call. As if people suddenly realized once again that the Brexit is indeed inevitable.
On the other hand, it became clear for the first time that the UK is aiming for a hard Brexit, despite the mitigating words about a new cooperation that benefits all parties. Let it be clear: a sovereign and independent country is not a member of the European Internal Market.

In the meantime, inflation forecasts in the UK are rising and the Bank of England will have to be vigilant: a second interest rate cut carries with it a risk of currency depreciation. The OECD is already warning of stagflation: high inflation combined with lagging economic growth. And Theresa May is trying to rescue the climate for foreign businesses in the UK with the early announcement that the British government wants to halve the corporate tax rate if the EU refuses to cooperate on a positive new cooperation agreement.

These uncertain economic conditions, and in particular the low exchange rate of the British pound, are already having consequences:

- British companies will become an attractive prey for foreign investors. US companies in particular will be interested in mergers and acquisitions in the UK while prices are at their current low.
- British companies will face difficulties as a result of declining revenues. Ryanair was one of the first companies to issue a profit warning; they expect to receive 13% to 15% less on plane tickets while the British pound is at its current low.
- Other companies will face conflicts with their trading partners. One example of this is the dispute between Unilever and Tesco about their previous price agreements. The pound's low exchange rate means Unilever is receiving less in relative terms for the products it sells to Tesco and wanted to raise its prices. Tesco refused to agree because it feared a loss of sales. The two reached an agreement and the English can enjoy their Marmite again.
- Yet more companies will raise their prices to compensate for the loss of income. Microsoft has already announced it will increase its prices for business software and cloud services for businesses as of January 1.

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How can we prepare in the Netherlands?

"I advise everyone to not worry, but stay alert", said the British ambassador to the Netherlands, Sir Geoffrey Adams.

Every company and every CEO must decide for themselves which steps they do and do not want to include in the preparations for the Brexit and the two-year exit procedure. The impact will be different for everyone. KPMG has seen that its clients are devoting time to the Brexit issue and also sees that there are still a lot of uncertainties.

It obviously makes sense for Dutch companies to take into account new uncertainties and new risks. Listed companies in particular owe it to their investors to provide insight into the potential impact of the Brexit. Companies are currently developing and calculating various potential scenarios for the future.

On the other hand, there are still major uncertainties at this moment about the impact of the Brexit and the future cooperation framework between the EU and the UK.

MOST IMPORTANT IN THESE UNCERTAIN TIMES: KEEP AN EYE ON THE NEWS

We are looking forward to the moment when the negotiations on the Brexit start and Theresa May provides more clarity about the form of cooperation the UK is looking to arrive at. Elements that are already seeping out via various news sources seem to indicate a hard Brexit. And as Donald Tusk has indicated, he believes there is only one alternative to a hard Brexit: no Brexit.

We will have to see what happens. Madam 'No' is in the meantime preparing for the first meeting with the European Council. And we will be happy to keep you posted on what happens next!

Is there anything organizations can already do today?

Try to create (broad outlines of) long-term scenarios that reflect the impact of the Brexit on your company. For instance, consider what happens when the British pound's exchange rate falls, if import levies rise, what effect do interest rates have, etc. Developing different scenarios at this early stage will make it easier to make an effective assessment of the consequences of the Brexit.

Take into account fluctuations in valuations and the volatility of the market. This can be translated into an adjustment of the discount rate and changes in the valuation of, for instance, companies, real estate and pension moneys. An IPO will be riskier.

Determine the risk of exchange rate changes. We can see now that the British pound exchange rate will be subject to more volatility in the coming years. If there is 'good' news, the exchange rate increases, and vice versa. A company that is sensitive to fluctuations in the British pound's exchange rate will want to hedge against that risk.

Higher transaction costs can already be taken into consideration. KPMG took stock of the impact of the Brexit on 14 large clients and concluded that even without increased levies transaction costs in trade could increase by as much as 22%.

Take into account higher costs for customs duties. Without free trade agreement, Dutch exporters seeking to export to the UK will face customs duties. In that case, Dutch companies will have to pay more than € 2.2 billion in customs duties for the Netherlands' 500 most important export products.

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What can KPMG do for you?

We will be happy to keep an eye on the news for you, but we can also help your company with a customs scan or advice from one of our Brexit experts

BREXIT CUSTOMS SCAN AND DATA ANALYSIS

The Brexit scan was specifically designed at KPMG's Tax Intelligence Solutions (TIS) and analyses customs and statistical data to determine risks and opportunities. It conducts a series of analytical checks and translates corporate data into value. The scan analyzes the effects of the Brexit (additional customs duties and handling costs).

The outcome of the Brexit scan, combined with the company structure, allows companies to reduce risks and identify opportunities at an early stage. The Brexit scan can be conducted for trade activities from the UK to the EU and vice versa.

KPMG COUNTRIES DESK AND BREXIT EXPERTS

KPMG in the Netherlands maintains a continuous dialogue with companies from countries such as Japan, Korea and the US about their Brexit strategy. Our Countries desk teams in the Netherlands, with know-how of the culture and language of the country of origin, are well equipped to provide these foreign-based companies with advice and guidance on their choice of location and implementation.

Our Brexit experts in the Netherlands are:

Gijs van Reen
Partner KPMG Nederland, Deal Advisory. Specialist in international mergers, acquisitions and IPOs. Brexit expert.

Robert van der Jagt
Partner KPMG Meijburg & Co and Chairman of KPMG's EU Tax Centre. Specialist in international tax law and EU law, including Brexit.